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Security Interests

Recommendations of the draft Legislative Guide on Secured Transactions

Note by the Secretariat*

Addendum

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* This document is submitted later than the required ten weeks prior to the start of the meeting because of the need to include changes decided at the tenth session of the Working Group held in New York from 1 to 5 May 2006.

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VII. Pre-default rights and obligations of the parties

Purpose

The purpose of the provisions of the law on pre-default rights and obligations of the parties is to enhance efficiency of secured transactions and reduce transaction costs and potential disputes by:

(a) Providing rules on additional terms for the security agreement;

(b) Eliminating the need to negotiate and draft terms to be included in the security agreement where the rules provide an acceptable basis for agreement;

(c) Providing a drafting aid or checklist of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement; and

(d) Encouraging party autonomy.

Party autonomy

86. The law should provide that, except as otherwise provided in [specify the provisions that may not be derogated from or varied by agreement, e.g. standard of conduct in the context of enforcement], the secured creditor and the grantor may derogate from or vary by agreement its provisions relating to their respective rights and obligations. Such an agreement does not affect the rights of any person that is not a party to the agreement.

[*Note to the Commission: The Commission may wish to note that, at its tenth session, the Working Group agreed that recommendation 86 should be moved to the general part of the draft Guide (see A/CN.9/603, para. 90). As that part had already been issued before the tenth session of the Working Group, this decision will be implemented at the next version of the general part.*]

Additional terms for the security agreement

87. The law should include rules that provide, in particular, for:

(a) An obligation of the secured creditor or the grantor in possession of the encumbered assets to take any steps necessary to preserve, insure and pay taxes for the encumbered assets;

(b) A right of the secured creditor to make reasonable use of the encumbered assets in its possession or to inspect encumbered assets in the possession of the grantor;

(c) A right of the secured creditor to receive any proceeds derived from the encumbered assets in its possession or to have the security right extended in any proceeds of encumbered assets in the possession of the grantor;

(d) A right of the secured creditor to freely assign the secured obligation in which case the security right follows, unless otherwise provided by law;

(e) A right of the secured creditor to be reimbursed for reasonable expenses for the preservation of encumbered assets in its possession;

(f) An obligation of the grantor to make up for an unexpected devaluation of the encumbered assets;

(g) An obligation of the secured creditor to return the encumbered assets in its possession or terminate the notice registered upon full payment of the secured obligation and termination of all commitments to extent credit.

VIII. Default and enforcement

Purpose

The purpose of the provisions of the law on default and enforcement is to:

(a) Provide clear and simple procedures for the enforcement of security rights after debtor default in a predictable and efficient manner;

(b) Provide procedures that maximize the potential realization value of the encumbered assets for the benefit of the grantor, the debtor or any other person that owes payment of the secured obligation, the secured creditor and other creditors with a right in the encumbered assets;

(c) Provide for expeditious judicial and, subject to appropriate safeguards, non-judicial methods for the secured creditor to realize the value of the encumbered assets;

(d) Coordinate the secured transactions enforcement regime with other law governing the enforcement of claims in encumbered assets, including insolvency law.

Application of this chapter to outright transfers of receivables

88. [*See A/CN.9/611*]

General standard of conduct

89. The law should provide that all parties must exercise their rights and perform their obligations under the recommendations of this chapter in good faith and in a commercially reasonable manner.

Liability for failure to comply with recommendations of this chapter

90. The law should provide that any party that fails to comply with the obligations arising under the recommendations of this chapter is liable for any damages caused by that failure.

Limitations to party autonomy in the context of the enforcement of a security right

91. The law should provide that rights arising under recommendation 89 cannot be waived unilaterally or varied by agreement at any time. Subject to that exception: (i) the grantor and any other person that owes payment or other performance of the secured obligation may waive unilaterally or vary by agreement any of their rights and remedies under the recommendations of this chapter only after default, and (ii) the secured creditor may waive unilaterally or by agreement any of its rights and

remedies under the recommendations of this chapter at any time. A variation by agreement does not affect the rights of any person not a party to the agreement. A person challenging an agreement has the burden of showing that it was made prior to default or is inconsistent with recommendation 90.

[*Note to the Commission: The Commission may wish to consider whether a waiver or variation of the liability arising under recommendation 90 should be addressed in recommendation 91 or left to other law.*]

Rights and remedies after default

92. As more specifically provided in other recommendations of this chapter, the law should provide that after default the grantor and the secured creditor have the rights and remedies provided in the recommendations of this chapter, in the security agreement (except to the extent inconsistent with the mandatory recommendations of this chapter) and in any other law.

Secured creditor rights and remedies

93. As more specifically provided in other recommendations of this chapter, the law should provide that after default the secured creditor is entitled to:

(a) Obtain possession of a tangible encumbered asset;

(b) Collect on an encumbered asset that is a receivable, negotiable instrument, right to payment of funds credited to a bank account or proceeds under an independent undertaking;

(c) Enforce rights under a negotiable document;

(d) Sell or otherwise dispose of, lease or license an encumbered asset;

(e) Propose to the grantor that the secured creditor accept an encumbered asset in total or partial satisfaction of the secured obligation; and

(f) Exercise any other right or remedy provided in the security agreement (except to the extent inconsistent with the mandatory recommendations of this chapter) or any other law.

Judicial and extrajudicial enforcement

94. As more specifically provided in other recommendations of this chapter, the law should provide that after default the secured creditor is entitled to exercise the rights and remedies described in recommendation 93:

(a) By applying to a court or other authority; or

(b) Without applying to a court or other authority.

Grantor rights and remedies

95. As more specifically provided in other recommendations of this chapter, the law should provide that after default the grantor is entitled to:

(a) Pay in full the secured obligation after default and until the disposition, acceptance or collection of an encumbered asset by the secured creditor, and thereby obtain a release from the security right of all encumbered assets securing that

obligation, provided that all commitments of the secured creditor to extend credit have terminated;

(b) Apply to a court or other authority for relief if the secured creditor has not complied or is not complying with its obligations under the recommendations of this chapter with respect to extrajudicial enforcement;

(c) Reject the proposal of the secured creditor to accept an encumbered asset in total or partial satisfaction of the secured obligation within the time limits prescribed by the recommendations of this chapter; and

(d) Exercise any other right or remedy provided in the security agreement (except to the extent inconsistent with the mandatory recommendations of this chapter) or any other law.

Summary judicial proceedings

96. The law should provide for summary judicial proceedings with respect to the exercise of rights and remedies of the secured creditor, the grantor, and any other person who owes performance of the secured obligation or claims to have a right in the encumbered assets.

Cumulative rights and remedies

97. The law should provide that the exercise of a right or remedy does not prevent the exercise of another right or remedy.

Rights and remedies with respect to the secured obligation

98. The law should provide that the exercise of rights or remedies with respect to an encumbered asset under this law does not prevent the secured creditor from exercising its rights or remedies with respect to the obligation secured by that encumbered asset. The exercise of rights or remedies with respect to a secured obligation does not prevent the secured creditor from exercising its rights or remedies with respect to an encumbered asset that secures that obligation.

Release of the encumbered assets after full payment

99. The law should provide that, after default and until the disposition, acceptance or collection of an encumbered asset by the secured creditor, the debtor, the grantor or any other interested party (e.g. a secured creditor whose security right has lower priority than that of the enforcing secured creditor, a guarantor or a co-owner of the encumbered assets) is entitled to pay the secured obligation in full. If all commitments to extend credit have terminated, the effect of such payment is to release from the security right all encumbered assets securing that obligation or, to the extent provided in other law, to subrogate any other interested party that makes the payment to the rights of the secured creditor.

Relief with respect to extrajudicial enforcement

100. The law should provide that the debtor, the grantor or other interested parties (e.g. a secured creditor, a guarantor or a co-owner of the encumbered assets) are entitled to apply to a court or other authority for relief if the secured creditor has not complied or is not complying with its obligations under the recommendations of this

chapter. The law should build safeguards into the process to discourage unfounded applications and to prevent any improper interference with or undue delay of the secured creditor's ability to enforce its security right.

Secured creditor's right to possession of an encumbered asset

101. The law should provide that after default the secured creditor is entitled to possession of a tangible encumbered asset.

Alternative A

The secured creditor is entitled to take possession of the encumbered asset without applying to a court or other authority if: (i) it has given the grantor and any person in possession of the encumbered asset notice of default and (ii) possession can be taken without the use or threat of force.

Alternative B

The secured creditor is entitled to take possession of the encumbered asset without applying to a court or other authority, if: (i) it has given the grantor and any person in possession of the encumbered asset notice of default and of its intention to pursue extrajudicial enforcement and (ii) possession can be taken without the use or threat of force, or other similar illegal act.

Collection of receivables

102. [*For recommendations 102 and 103, see A/CN.9/611.*]

Negotiable instruments

104. [*For recommendations 104 and 105, see A/CN.9/611/Add.1.*]

Proceeds under an independent undertaking

106. [*See A/CN.9/611/Add.1.*]

Rights to payment of funds credited to a bank account

106 bis. [*For recommendations 106 bis, 107 and 108, see A/CN.9/611/Add.1.*]

Negotiable documents

109. [*See A/CN.9/611/Add.1.*]

Disposition of encumbered assets

110. As more specifically provided in other recommendations of this chapter, the law should provide that after default a secured creditor is entitled to sell or otherwise dispose of, lease or license an encumbered asset pursuant to recommendation 93 (d).

110 bis. The law should provide that a secured creditor that disposes of encumbered assets without applying to a court or other authority may select the method, manner, time, place, and other aspects of the disposition.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that this recommendation is subject to the standard of good faith and commercial reasonableness set out in recommendation 89. It will also explain that the purpose and effect of this recommendation is to provide a balance between the interests of both the grantor (and its other creditors) and the secured creditor in enabling flexibility in the methods used to dispose of the encumbered assets toward the end of obtaining an economically effective enforcement, while at the same time protecting the grantor against actions taken by the secured creditor that, in the commercial context, are not reasonable. The commentary will also explain that the secured creditor need not be in possession of the encumbered assets to exercise its rights and remedies under this chapter.*]

Advance notice with respect to extrajudicial disposition of encumbered assets

111. The law should require the secured creditor to give notice with respect to extrajudicial disposition of an encumbered asset after default. The law should:

(a) Specify that the notice should be given to: (i) the grantor, the debtor and any other person that owes payment of the secured obligation, (ii) any person with rights in the encumbered asset that, prior to the sending of the notice by the secured creditor to the grantor, has notified in writing the secured creditor of those rights, and (iii) any other secured creditor that, more than [...] days before the notice is sent to the grantor, has registered a notice of a security right in the encumbered asset under the name of the grantor or that was in possession of the encumbered asset at the time it was seized by the secured creditor;

(b) State the manner in which the notice is to be given, its timing, and its minimum contents, including whether the notice to the grantor should contain an accounting of the amount then owed and a reference to the right of the debtor or the grantor to obtain the release of the encumbered assets from the security right under recommendation 98;

(c) Provide that the notice should be in a language that is reasonably expected to inform its recipients about its contents (notice to the grantor is sufficient if it is in the language of the security agreement and, if the security right was made effective against third parties by registration, notice to all other persons is sufficient if it is in the language of the registry);

(d) Address the legal consequences of failure to comply with the recommendations governing the notice; and

(e) List circumstances in which the notice need not be given either because the time delay associated with requiring advance notice could have a negative effect on the realization value of the encumbered assets (as in the case of perishable tangibles or other assets whose value may decline speedily) or because the encumbered assets are of a sort sold on a recognized market (thereby obviating the need for advance notice).

112. The law should provide rules ensuring that the notice referred to in recommendation 111 can be given in an efficient, timely and reliable way so as to protect the grantor or other interested parties, while, at the same time, avoiding having a negative effect on the secured creditor's remedies and the potential realization value of the encumbered assets.

[Note to the Commission: The Commission may wish to note that the commentary will explain that these rules should balance the interest of the secured creditor in having the flexibility to dispose of the encumbered asset promptly in order to take advantage of favourable market conditions (an interest that also benefits the grantor and other interested parties) with the interest of the grantor and those other parties in obtaining notice of the disposition sufficiently before the disposition in order to take actions that might further protect their interests (such as locating potential buyers for the encumbered asset or attending a public disposition of the encumbered asset to verify the secured creditor's compliance with its obligations under this chapter. The commentary will also explain that the recommendation does not require registration of the notice because the notice meets the policy goals that could be served by registration. The Working Group may wish to define notice as written notice, except where otherwise provided in the law.]

Acceptance of encumbered assets in satisfaction of the secured obligation

113. The law should provide that after default a secured creditor may propose to accept, without applying to a court or other authority, one or more of the encumbered assets in total or partial satisfaction of the secured obligation.

114. The law should provide that a secured creditor that proposes to accept an encumbered asset in total or partial satisfaction of the secured obligation must send the proposal, specifying the amount owed as of the date the proposal is sent and the amount of the obligation that is proposed to be satisfied by accepting the encumbered asset to:

(a) The grantor, the debtor and any other person that owes payment of the secured obligation (e.g. a guarantor);

(b) Any person with rights in the encumbered asset that, more than [...] days prior to the sending of the proposal by the secured creditor to the grantor, has notified in writing the secured creditor of those rights; and

(c) Any other secured creditor that, more than [...] days before the proposal is sent to the grantor, has registered a notice of a security right in the encumbered asset in the name of the grantor or that was in possession of the encumbered asset at the time it was seized by the secured creditor.

115. The law should provide that, if a person to which a proposal to accept an encumbered asset in total or partial satisfaction of the secured obligation must be sent under recommendation 114 objects in writing to such a proposal within [a short time, such as 20 days] after the proposal is sent, the secured creditor may not proceed with the proposal.

Distribution of proceeds of enforcement

116. The law should provide that, in the case of extrajudicial enforcement, the enforcing secured creditor must apply the net proceeds of its enforcement (after deducting costs of enforcement) to the secured obligations. Except as provided in recommendation 117, the enforcing secured creditor must pay any surplus remaining after such application to subordinate competing claimants, that, prior to any distribution of the surplus, gave written notice of their claims to any surplus to

the enforcing secured creditor. Any balance remaining must be remitted to the grantor.

117. The law should also provide that, in the case of extrajudicial enforcement, whether or not there is any dispute as to the entitlement of any competing claimant or as to the priority of payment, the enforcing secured creditor may, in accordance with generally applicable procedural rules, pay the surplus to a competent judicial or other authority or to a public deposit fund for distribution. In the case of such payment, the surplus should be applied in accordance with the priority rules of this law.

118. The law should provide that distribution of the proceeds realized by a judicial disposition or other officially administered process is to be made in accordance with general rules of the State governing execution proceedings, but in accordance with the priority rules of this law.

119. The law should provide that the debtor and any other person that owes payment of the secured obligation are liable for any shortfall still owing after application of the net proceeds of enforcement to the secured obligation.

Right of prior-ranking secured creditor to take over enforcement

120. The law should provide that, at any time before final disposition, acceptance or collection of an encumbered asset, a secured creditor whose security right has priority over that of the enforcing secured creditor or judgement creditor is entitled to take control of the enforcement process. The right to take control includes the right to continue enforcement, enforce by a different method provided in the recommendations of this chapter, and choose whether or not any remedy under the recommendations of this chapter will be administered by a court or other authority.

[*Note to the Commission: The Commission may wish to note that the commentary will explain that the secured creditor with priority has the right to substitute its own enforcement process under this law for judgement enforcement proceedings initiated by a subordinate judgement creditor under other law but does not have the right to continue the enforcement process initiated by the judgement creditor under that other law.*]

Title or other right acquired through non-judicial disposition

121. The law should provide that, if a secured creditor disposes of an encumbered asset without applying to a court or other authority, the person that acquires the asset in good faith pursuant to the disposition (i) acquires the grantor's right in the asset subject to rights that had priority over the security right of the enforcing secured creditor and (ii) takes free of the rights of, the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor. The same rule applies to an encumbered asset acquired by a secured creditor that has accepted the encumbered asset in total or partial satisfaction of the secured obligation.

122. The law should provide that, if a secured creditor disposes of a partial right in an encumbered asset or leases or licenses an encumbered asset without applying to a court or other authority, the person that acquires the partial right, lease or licence in good faith pursuant to the disposition, lease or licence (i) acquires the grantor's

right in the asset to the extent of the disposition, lease or licence subject to rights that had priority over the security right of the enforcing secured creditor and (ii) takes free of the rights of the enforcing secured creditor and any competing claimant whose right has a lower priority than that of the enforcing secured creditor.

Title or other right acquired through judicial disposition

123. The law should provide that, if a secured creditor disposes of an encumbered asset through a judicial or other officially administered process, the title or other right acquired by the transferee is determined by the general rules of the State governing execution proceedings.

Intersection of movable and immovable property enforcement regimes

124. The law should provide that:

(a) A security right in attachments to immovable property may be enforced in accordance with either this law or the law governing enforcement of encumbrances on immovable property; and

(b) If an obligation to a secured creditor is secured by both a security right in an encumbered asset of the grantor and by an encumbrance on an immovable property of the grantor, the secured creditor may enforce: (i) both the security right and the encumbrance under the law governing enforcement of encumbrances on immovable property or (ii) the security right under this law and the encumbrance under the law governing enforcement of encumbrances on immovable property.

[*Note to the Commission: The Commission may wish to note that the law should be coordinated with general civil procedure law to provide a right for secured creditors to intervene in court proceedings initiated by other creditors of the grantor so as to protect security rights and to ensure the same priority status of security rights as under the law.*]